Ernst Welteke: Different aspects of change in today's financial systems

Speech by Mr Ernst Welteke, President of the Deutsche Bundesbank, at the Joint Bundesbank/BIS conference on "Recent developments in financial systems and the challenges for economic policy", held in Frankfurt, 28-29 September 2000.

I.

Ladies and Gentlemen,

Welcome to Frankfurt, and welcome to our conference. I am delighted to see that so many of you have been able to take up our invitation.

I am glad to announce distinguished members from international institutions; most of all from the Bank for International Settlement (BIS), which is co-organising this conference with the Bundesbank, but also from the IMF.

In addition, I have the pleasure to welcome colleagues from central banks in the United States, Japan, and obviously from Europe, who will present their views.

Further, we are happy to have several speakers from the private financial sector. And last, but by no means least, from academe.

Bankers certainly understand the same kind of language. So let me say: I hope your attendance here, seen as an investment, will yield you a decent return.

In opening this conference, I would like to stress that this is the first time that the Bank for International Settlements and the Deutsche Bundesbank have co-hosted such an event. What is more, here in Frankfurt, the "capital of the euro", if I may say so.

There are, of course, good reasons for this venue. The perception is becoming increasingly accepted that central banks also have a mandate to ensure the stability of the whole financial system.

The reasons for that are obvious. A well-functioning financial system is an essential precondition for safeguarding price stability without impairing developments in the real economy.

In this context, I may assume that it is well-known that the Bundesbank has a long tradition of stability-oriented policies.

Further, it is the Bank for International Settlements (BIS), as the "central bank for central banks", which plays a prominent role in the ongoing international endeavours to foster financial stability.

For this reason, the Financial Stability Forum - set up last year at the suggestion of my predecessor, Professor Tietmeyer - is very fitly accommodated under the wing of the BIS. The Basel Committee on Banking Supervision also meets at the BIS.

So let us take the big view, and focus on the different aspects of change in today's financial systems. Indeed, these ongoing changes appear to be of a global nature in many respects. In Europe, however, they undoubtedly need to be seen against the background of European Monetary Union, as well.

II.

In the international financial markets, since the 1960s, we have been witnessing a fast and furious pace of development. The development here warrants the general designation of "globalisation" more than in any other sector.

The major financial markets have grown closer and closer together. In fact, the barriers to cross-border capital movements have increasingly been lifted as a result of political measures and technological advances.

The global integration of the financial markets is anything but an end in itself. Not only does it open up to investors a broad new range of investment opportunities for diversifying portfolio risks. It also improves the refinancing options open to issuers of securities. In addition, it tends to boost securities trading.

A high degree of liquidity in trading is a key prerequisite of efficient price formation in the capital markets. And, after all, efficient capital markets are an essential component of a well-functioning economy.

Global integration has, of course, its drawbacks: the reason for this is that the openness of the financial markets may also serve to spread turbulences.

Risks may have their roots in major groups of investors, in the shape of overly credit-financed leverage. Also, to some extent, in the form of an observed tendency towards herding behaviour.

What can a central bank do to counteract the dangers presented by globalisation?

The stance of the Bundesbank on this has been quite clear. Let me say it again: a good policy creates incentives for market players to cope consciously with risks on their own. Thus, a good policy need not set new controls on, or obstacles to, international capital movements.

Rather, a good policy excels in shaping appropriate underlying macroeconomic conditions. For it is precisely when stable monetary conditions are lacking that the risks associated with financial assets become difficult to evaluate.

I think this stance is appropriate, at least for the large, developed economies with mature financial markets. However, an important lesson of the crises in Asia in 1997 - and thereafter also in Russia and Latin America - is: for the so-called “emerging economies” a gradual and measured integration strategy is to be pursued.

Further liberalisation of the capital markets promises only success when and where they have reached a recognisably high degree of structural maturity and stability.

Certainly, a sound banking system and well-functioning banking supervision are needed for that. Here, it would be irresponsible to take the second step before the first one.

III.

Eventually, maybe already in the near future, the direct cost of executing securities transactions will no longer hinder further integration of the financial systems. Given the progress made in technology and integration, one may at least come to this conclusion.

We are therefore likely to see investment banking increase rapidly in importance. We can also expect further professionalisation of investment decisions, for instance, in the form of investment funds.

In the bond markets of the euro area, government bonds and bank debt securities still greatly predominate. Nevertheless, a strong increase in corporate bond issuance is already apparent. And equity markets are growing rapidly in continental Europe.

The advance of market-based financing structures is changing the role played by banks in the financing cycle.

For one thing, the refinancing of banks is shifting from the traditional taking of time and savings-deposits to the issuing of debt securities of their own.

Moreover, simple corporate lending is losing ground as a source of income to commissions stemming from issuance or derivatives business.

Of course, precisely where the structural change in the European banking sector is leading remains uncertain. But there are signs that banks as a whole are keeping their lending business focused on the domestic markets.

This is one reason why a decentralised banking supervision system - still a national responsibility - is objectively warranted in the European Monetary Union. One also has to consider the persistent differences from country to country - despite the harmonisation of European banking legislation. Local supervision may therefore be more efficient, given its better knowledge of the market and greater proximity to the banks.

Nevertheless one has to take due account of the banks' cross-border activities. For this reason, central banks and the supervisory authorities already cooperate closely today on a multilateral basis.

New technologies and the intensification of competition point to comprehensive consolidation in the banking sector in the next few years. As a consequence, banking supervisors are naturally facing correspondingly great challenges.

Clearly, questions of systemic stability are moving to the top of the agenda for banking supervisors.

IV.

Besides the globalisation of the financial markets, the launch of European Monetary Union constitutes a particular challenge of its own. Monetary policy is now being applied to a major financial area. Moreover, this area is undergoing a very rapid process of change, partly propelled by the euro itself.

Let me say from a central bank's perspective: the main requirement for financial systems is generally that central bank measures be transmitted via the system as smoothly as possible to the goods and labour markets.

A central bank must know the transmission channels of its measures. We in Europe are engaging in an essential learning process. We must therefore keep a constant and watchful eye on the remaining differences within the euro area. And we have to be aware of the structural and behavioural changes in the financial systems.

Further, one has to ensure that the signals set by monetary policy makers are "properly" understood by the market players. This is, of course, primarily the responsibility of the central bank itself: we have to pursue a comprehensible strategy and explain our decisions appropriately.

In the Eurosystem, monetary policy continues to be oriented towards keeping the expansion of the money stock in line with the real growth potential of the economy. This makes our actions calculable. It minimises uncertainty about price and interest-rate movements. In this way, we can greatly help to undermine a major potential cause of instability in the financial system.

The second strategic pillar is the appraisal of inflation prospects, using a broad range of real economic and financial indicators.

At this juncture, allow me to repeat my point as clearly as I can: the final goal of European monetary policy is to ensure price stability. That is to say, to safeguard an inflation rate in the euro area of less than 2% per annum.

It should not be doubted that the external value of the euro plays an important part in the attainment of that objective. Insofar, there is no such thing as "benign" neglect - neglect is always "malign".

Price stability will eventually help the euro to attain a greater role as an international reserve and investment currency as well. Such a role will not only be in keeping with the sheer economic weight of the euro area. It will also reflect the high degree of external integration in the global financial and product markets.

V.

Globalisation, technological progress, competition and European Monetary Union: ladies and gentlemen, these well-known buzz-words have all figured several times in my opening remarks.

In the context of monetary policy, and of the responsibility for stable financial systems, these words do indeed have far-reaching implications. I hope that I have been able to bring it home to you once again: further, major structural changes lie ahead.

These changes and advances in the financial system will open up many new options.

They naturally also imply uncertainties. These are, however, unavoidable if competitive trends are to remain dynamic. But they likewise imply a real prospect of greater economic prosperity.

The fundamental prerequisite of such greater prosperity remains, of course, order and stability in the financial system.

Needless to say, there are major challenges ahead; cut-and-paste approaches will not get us very far. At the same time, it is important to learn from the experience and perceptions of others.

Therefore, the two days that we are about to devote to these matters seem to me a very worthwhile investment.